

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 15376
[REDACTED],)	
)	DECISION
Petitioners.)	
_____)	

On December 29, 2000, the Idaho State Tax Commission (Tax Commission) issued a Notice of Deficiency Determination to [Redacted] (petitioners), proposing additional income tax, penalty, and interest for the taxable year 1993, in the total amount of \$9,846. The petitioners filed a timely protest and petition for redetermination. The Tax Commission, having reviewed the file, hereby issues its decision.

FACTS

In General

According to the Tax Commission records, the petitioners filed an Idaho resident income tax return for taxable years 1992, 1993, and 1994. The 1992 return was filed in 1997. The 1993 and 1994 returns were filed in 1999. The petitioners' 1992 through 1994 Idaho income tax returns reflect zero Idaho taxable income.

The petitioners' 1993 Idaho income tax return was selected for audit. On December 29, 2000, the Income Tax Audit Bureau (hereafter "Audit") issued a Notice of Deficiency Determination disallowing the net operating loss carryforward claimed on petitioners' 1993 Idaho income tax return. Additionally, Audit disallowed a capital loss carryforward that had been incurred in a taxable year prior to 1992 and claimed as a deduction in 1993.

Net Operating Loss Carryforward

When the petitioners filed their 1993 Idaho resident income tax return, the petitioners claimed an Idaho net operating loss carryforward of \$350,343.

Audit disallowed \$326,244 of the \$350,343 since the loss or losses were incurred prior to the petitioners' becoming Idaho residents. The remaining \$23,799 of loss, which represents the amount of Idaho net operating loss incurred by the petitioners in 1992, was disallowed by Audit since the petitioners had not documented that the loss was available as a carryforward to taxable year 1993. It is Audit's position that the petitioners moved into Idaho sometime in 1991 and should have filed as Idaho part-year residents. Since the petitioners have not filed a 1991 Idaho income tax return, it is unclear how much, if any, of the 1992 Idaho net operating loss would be available as a net operating loss carryforward to 1993. Because the petitioners' 1992 Idaho income tax return was not timely filed, the option to forego the Idaho net operating loss carryback period was not available to the petitioner's; therefore, the 1992 Idaho net operating loss is required by Idaho statute to be carried back three years before it can be carried forward.

Capital Loss Carryforward

The petitioners claimed a \$13,136 capital loss carryforward as a deduction in arriving at federal taxable income. Audit disallowed the \$13,136 capital loss carryforward since the capital loss was incurred in a taxable year prior to the petitioners' becoming Idaho residents.

Petitioners' Argument

In the petitioners' petition for redetermination dated January 23, 2001, the petitioners, through their representative, make the following argument:

If the taxpayer had been a resident of the State of Idaho during the time that the operating and capital losses had been incurred and utilized for federal tax purposes, the taxpayer would have had the benefit of those deductions and losses for State of Idaho tax purposes. Thus, to the extent that these tax attributes are

subject to restoration into federal income due to recovery of depreciation deductions or taxable reduction of the debt used to fund the losses, the taxpayer would be exposed to State of Idaho taxation with respect to items of loss and deduction recovery that were never allowed for Idaho tax purposes. The taxpayer is being denied these deductions solely because the taxpayer was a nonresident of the State of Idaho when these tax attributes were generated and such denial has the result of levying taxation without regard to the taxpayer's real economics.

Thus, the . . . statutes of the State of Idaho discriminate between residents and nonresidents in a manner that cannot be adequately justified by the State of Idaho. The State of Idaho is merely seeking to obtain a tax windfall from a taxpayer that may have no economic gain during the life of his respective business and investment activities by only considering the income portion of the activities.

Therefore, the . . . statutes are unconstitutional under the Privileges and Immunities Clause, U.S. Constitution, Article IV, Section 2, which provides "(t)he citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States." The Supreme Court of the United States has determined that provisions of a state law that effectively deny only nonresident taxpayers an income tax deduction are not consistent with the constitutional command of the Privileges and Immunities Clause. *Lunding v. New York Tax Appeals Tribunal*, 522 U.S. 287(1998). . . .

IDAHO LAW AND ANALYSIS ¹

The starting point for computing Idaho taxable income is federal taxable income as defined in the Internal Revenue Code. Idaho Code section 63-3002. In computing Idaho taxable income, any federal net operating loss is added to federal taxable income. Idaho Code section 63-3022(c). Any capital loss carryforward included in federal taxable income that was incurred before a taxpayer was a resident of Idaho is added to federal taxable income. Idaho Code section 63-3022(k). Any Idaho net operating loss is then subtracted. Idaho Code section 63-3022(d)(1).

Audit applied subsections of Idaho Code section 63-3022 in disallowing the petitioners' net operating loss and capital loss carryforwards. Idaho Code section 63-3022(d)(2) stated "[n]et

¹ Unless otherwise indicated, all Idaho Code section references throughout the remainder of this decision refer to the Idaho Code as it read in 1993.

operating losses incurred by a person, other than a corporation, in business activities not taxable by Idaho may not be subtracted.” Idaho Code section 63-3022(k) stated “[i]n the case of persons, other than corporations, add any capital loss deducted which was incurred in business activities not taxable by Idaho at the time such loss was incurred.”

Capital Loss and Net Operating Loss Carryforward Deductions

The petitioner is seeking a deduction for operating losses and a capital loss that were not from Idaho sources and were incurred prior to the petitioners becoming Idaho residents. The U.S. Supreme Court stated in *New Colonial Ice Company, Inc. v. Helvering*, 292 U.S. 435, 54 S.Ct. 788, that “[w]hether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.” They further stated that “[o]bviously, therefore, a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms.”

The Idaho legislature has spoken with respect to the type of net operating loss that will be allowed as a deduction in arriving at Idaho taxable income for both residents and nonresidents. To the extent that a resident’s or nonresident’s Idaho taxable income, subject to certain modifications, is less than zero, the resident or nonresident has an Idaho net operating loss. Idaho Code section 63-3021. To the extent that a resident or nonresident has an Idaho net operating loss, the Idaho net operating loss, subject to the carryback and carryforward provisions of Idaho Code, is deductible. Idaho Code section 63-3022(d)(1). Furthermore, a loss incurred in business activities not taxable by Idaho, may not be subtracted from federal taxable income. Idaho Code section 63-3022(d)(2). Therefore, \$326,244 of the \$350,343 net operating loss carryforward that the petitioners are attempting to claim as a deduction in 1993 is not an allowable deduction under Idaho law.

The Idaho legislature has spoken with respect to the type of capital loss carryforward that will be allowed as a deduction. A capital loss incurred in business activities not taxable by Idaho may not be subtracted from federal taxable income. Idaho Code section 63-3022(k). The capital loss carryforward that the petitioners are attempting to claim as a deduction after becoming residents of Idaho does not appear to fall within the category of capital loss carryforward deduction allowed by the Idaho statute.

Constitutional Argument

As discussed above, the petitioners argue that the Idaho Code sections relied upon by Audit to disallow the deductions are unconstitutional. The petitioners believe that the Idaho statutes violate the Privileges and Immunities Clause found in Article IV, Section 2 of the U.S. Constitution. As support for their position, the petitioners cite *Lunding v. New York Tax Appeals Tribunal*, 522 U.S. 287, 118 S.Ct. 766 (1998), as support for their position.

The *Lunding* case dealt with the disallowance of a nonresident's deduction for alimony expenses. The Court in *Lunding* stated that:

Although the Privileges and Immunities Clause does not prevent States from requiring nonresidents to allocate income and deductions based on their in-state activities in the manner described in *Shaffer* and *Travis*, those opinions do not automatically guarantee that a State may disallow nonresident taxpayers every manner of nonbusiness deduction on the assumption that such amounts are inevitably allocable to the State in which the taxpayer resides. Alimony obligations are unlike other expenses that can be related to activities conducted in a particular State or property held there. And as a personal obligation that generally correlates with a taxpayer's total income or wealth, alimony bears some relationship to earnings regardless of their source. . . .

Id. at 782.

The Idaho State Tax Commission does not have the authority to declare an act of the Idaho legislature unconstitutional, *Wanke v. Ziebarth Const. Co.*, 69 Idaho 64, 75, 202 P.2d 384, 391 (1948); however, the Commission is empowered to review the facts and circumstances

presented in an administrative protest in light of the prevailing constitutional limitations and to provide its opinions and insights into whether a violation of the federal or Idaho constitution has occurred. *Id.*

The *Lunding* case dealt with nonresident's being denied a deduction for a personal expense (alimony) that New York residents were entitled to claim. The case before the Tax Commission deals with losses that were incurred prior to the petitioner's becoming subject to Idaho's jurisdiction to tax rather than nonresident's being denied a deduction for a personal expense that residents could deduct. Thus, the facts in this case are vastly different than the facts in the *Lunding* case, and the Tax Commission does not believe that the courts would find the *Lunding* case to be applicable.

The courts have long held that because state legislatures must draw some distinctions in light of "local needs," they have considerable discretion in formulating tax policy. *Madden v. Commonwealth of Kentucky*, 309 U.S. 83, 88 (1940). The Idaho legislature, in formulating Idaho's tax policy, has made clear the type of loss carryforwards that will not be allowed as a deduction in arriving at Idaho taxable income. The Idaho legislature has specifically excluded as a deduction in arriving at Idaho taxable income the type of loss carryforwards that the petitioners are seeking to deduct.

FINDINGS

Capital Loss and Net Operating Loss Carryforward Deductions

It is well established in Idaho law that a taxpayer claiming a deduction, exemption, or credit bears the burden of establishing his or its entitlement to the same, both as to law and fact. Further, statutes allowing deductions and exemptions are "construed strongly against the

taxpayer.” *Potlatch Corp. v. Idaho State Tax Com’n*, 128 Idaho 387 (1996), citing *Hecla Mining Co. v. Idaho Tax Com’n*, 108 Idaho 147, 151, 697 P.2d 1161, 1165 (1985).

The petitioners have not met their burden of establishing their entitlement to the deductions at issue. Therefore, the disallowance of the net operating loss carryforward deductions and the capital loss carryforward deduction are sustained.

Penalty

The Notice of Deficiency Determination contains a substantial understatement penalty in accordance with Idaho Code section 63-3046. Idaho Code section 63-3046 states in pertinent part:

§ 63-3046. ADDITIONS TO THE TAX IN CASE OF DEFICIENCY. . .

(d) (1) If there is a substantial understatement of tax for any taxable year, there shall be added to the tax an amount equal to ten per cent (10%) of the amount of any underpayment attributable to such understatement.

(2) For purposes of this subsection, there is a substantial understatement of tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of:

(i) Ten per cent (10%) of the tax required to be shown on the return for the taxable year, or

(ii) Five thousand dollars (\$5,000).

(3) In the case of a corporation, paragraph (d)(2)(ii) of this section shall be applied by substituting ten thousand dollars (\$10,000) for five thousand dollars (\$5,000).

(4) For purposes of paragraph (d)(2) of this section, the term "understatement" means the excess of:

(i) The amount of tax required to be shown on the return for the taxable year, over

(ii) The amount of the tax imposed which is shown on the return.

(5) The amount of the understatement under paragraph (4) shall be reduced by that portion of the understatement which is attributable to:

(i) The tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

(ii) Any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.

...

(7) The state tax commission may waive all or any part of the addition to tax provided by this section on a showing by the taxpayer that there was reasonable

cause for the understatement (or part thereof) and that the taxpayer acted in good faith

The computation of the amount of the understatement of tax and the determination that it is substantial are mechanical processes under subsections (2), (3) and (4) of the quoted subsection. The understatements here are substantial within the meaning of those provisions to the extent the audit treatment of the protested items is upheld herein.

The understatement subject to the penalty must be reduced if there is “substantial authority” for the taxpayer’s position or to the extent the facts supporting the taxpayer’s treatment are adequately disclosed in the tax return. Based upon the facts and circumstances in this case, the Tax Commission does not believe that the petitioners had “substantial authority” for their position or provided adequate disclosure in their return. Therefore, Idaho Code section 63-3046(d) penalty is sustained.

Offsets Against Idaho Tax Liability

Based upon a review of the petitioners’ 1993 Idaho income tax return as originally filed with the Tax Commission, the Tax Commission finds that the petitioners are entitled an offset against their Idaho tax liability of \$334, which was not taken into consideration in the Notice of Deficiency Determination. Therefore, the Notice of Deficiency Determination dated December 29, 2000, is hereby modified to provide for a \$334 offset against the petitioners’ Idaho income tax liability.

WHEREFORE, the Notice of Deficiency Determination dated December 29, 2000, is hereby MODIFIED and, as so modified, is APPROVED AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioners pay the following tax, penalty, and interest (calculated through August 15, 2002):

YEAR	TAX	PENALTY	INTEREST	TOTAL DUE
1993	\$5,626	\$563	\$3,732	\$9,921

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the petitioners' right to appeal this decision is enclosed with this decision.

DATED this ____ day of _____, 2002.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2002, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]
[Redacted]

Receipt No. [Redacted]

ADMINISTRATIVE ASSISTANT 1